State Board of Land Commissioners
August 3, 2006
Regular Agenda
(Revised memo)

<u>SUBJECT</u>
Approve distributions to endowment beneficiaries for fiscal year 2008

<u>OVERVIEW</u>
The Endowment Fund Investment Board recommends, for consideration by the Land Board, two options for distributions in fiscal 2008.

Option 1
An enhanced Spending Policy is being developed, but it is still undergoing testing. While the "Proposed Policy" has not yet been approved by the EFIB, the $46.5 million of fiscal 2008 distributions recommended by the "Proposed Policy" appear to be achievable and represent an appropriate balance between the interests of current and future beneficiaries, taking into account the current level of earnings reserves and past and expected fund revenues.

Distributions from the Proposed Policy (at the 200% Safety Margin scenario) will retain a substantial reserve for the endowment funds while providing a 30% increase in distributions over fiscal 2007. Compared to 2007 distributions, three endowments increase, three hold steady, and two decline 10%.

Option 2
The existing approved Spending Policy, used last year to determine distributions, is to pay out 5% of the last three years' balance of the Permanent Funds of each of the endowments. With two exceptions, distributions that result from using this existing policy appear to be achievable and represent an appropriate balance between the interests of current and future beneficiaries, taking into account the current level of earnings reserves and past and expected fund revenues. For the two endowments with the lowest earnings reserve coverage, Penitentiary and School of Science, it is recommended to use the lower level of distributions specified by the Proposed Policy explained as Option 1.

The $38.6 million of distributions from the existing policy will result in retention of the same or more reserves for six of eight endowments compared to the Proposed Policy while providing a 7.7% increase in distributions over fiscal 2007. Compared to 2007, six endowments increase 9%-10% while two decline 10%.

	Approved	Options for FY 2008 Distribution			
		Proposed "Safer" Scenario		Existing 5% Policy*	
	FY2007	***Dollars***	***% Change***	***Dollars***	***% Change***
Public Schools	24,648,200	32,484,000	31.8%	26,995,000	9.5%
Ag College	661,200	661,200	0.0%	725,000	9.6%
Charitable Instit.	2,361,300	2,361,300	0.0%	2,582,000	9.3%
Normal School	2,115,700	2,506,400	18.5%	2,310,000	9.2%
Penitentiary	809,300	728,400	-10.0%	728,000	-10.0%
School of Science	2,375,800	2,138,200	-10.0%	2,138,000	-10.0%
State Hosp. South	1,051,500	3,678,300	249.8%	1,149,000	9.3%
University	1,822,600	1,948,800	6.9%	1,990,000	9.2%
	35,845,600	46,506,600	29.7%	38,617,000	7.7%

* Except for Penitentiary and School of Science, where the proposed "Safer" Scenario was used

BOARD ACTION

Controller Johnson moved the EFIB recommendation with the existing spending policy of $38.6 million, including two exceptions for the Penitentiary and School of Science distributions. Controller Johnson further directed that approval of the proposed spending policy be deferred and that the Task Force work with the EFIB on the issue of the transfer to the Permanent Fund. Secretary of State Ysursa seconded the motion. The motion carried on a vote of 5-0.

Endowment Fund Spending Policy

Prepared for:

Board of Land Commissioners Meeting

August 8, 2006

Spending Policy: Decision Time

- As part of the budget process, the Land Board needs to approve endowment fund distributions for FY2008 at its August 2006 meeting
  - Endowment Fund Investment Board will meet August 7th to review proposed distributions and provide their formal recommendation to the Land Board
- Approved amounts will be considered by the beneficiaries in submitting their full budgets to the Division of Financial Management September 1
- Land Board also has option to transfer from Earnings Reserve to Permanent, but that option has not been explored

Executive Summary

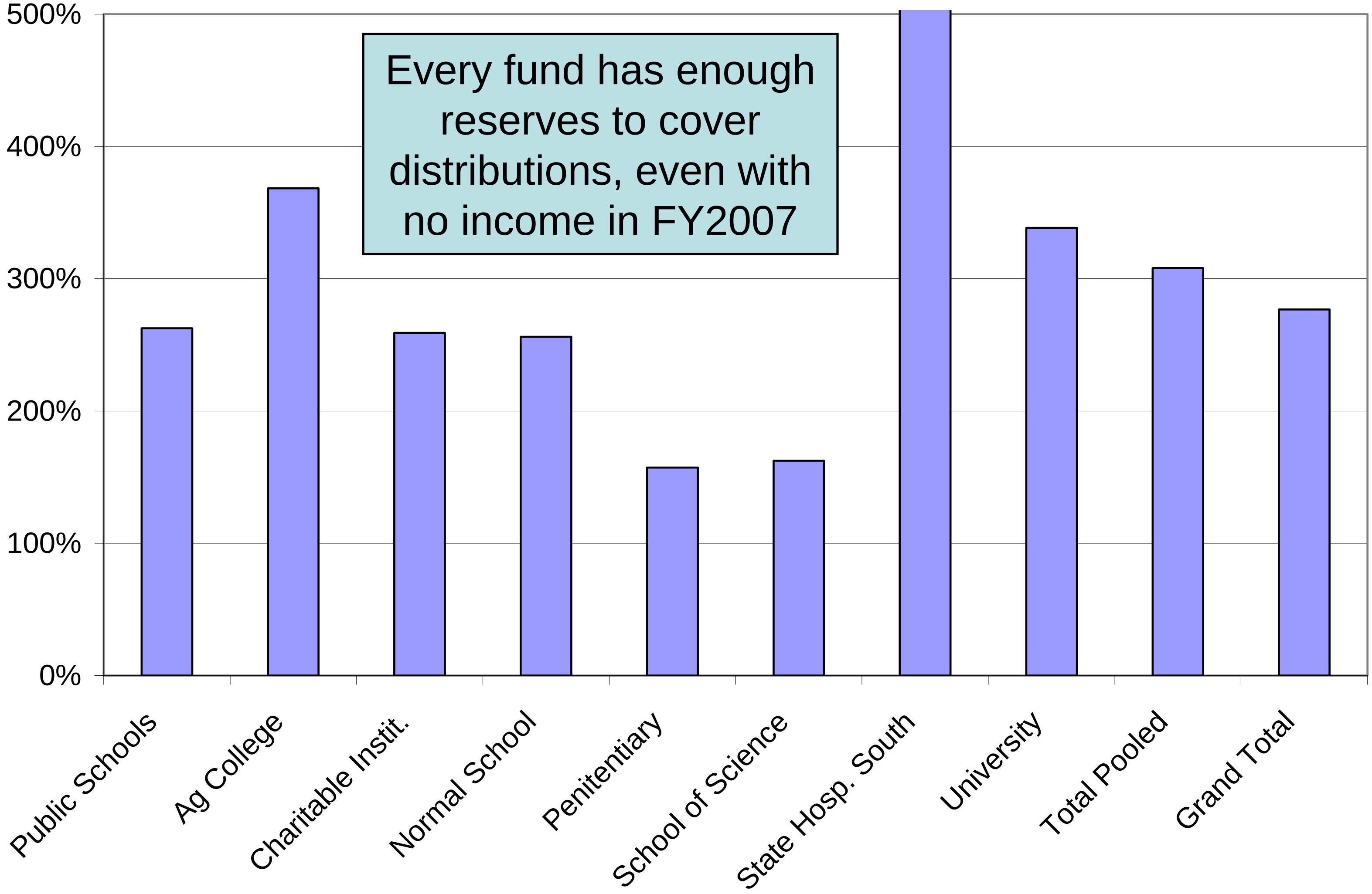
- Payout of fund revenues has been relatively low in recent years, Earnings Reserve balances have hit new highs, and further improvement in FY2007 is likely
- The existing Spending Policy can be enhanced, so a new policy, based on payout levels and reserve coverage, has been developed which results in increased total distributions relative to 2007's level of $35 million:
  - $52 million in a scenario with a 100% safety margin
  - $47 million in a scenario with a 200% safety margin
- Even with the proposed increases in distributions, the likelihood of a future cutback is low
  - Payouts for all endowments remain below 100% of average Net Revenues
  - Every fund is expected to have 200% of 2008 distributions in reserve at the end of 2007

Good News

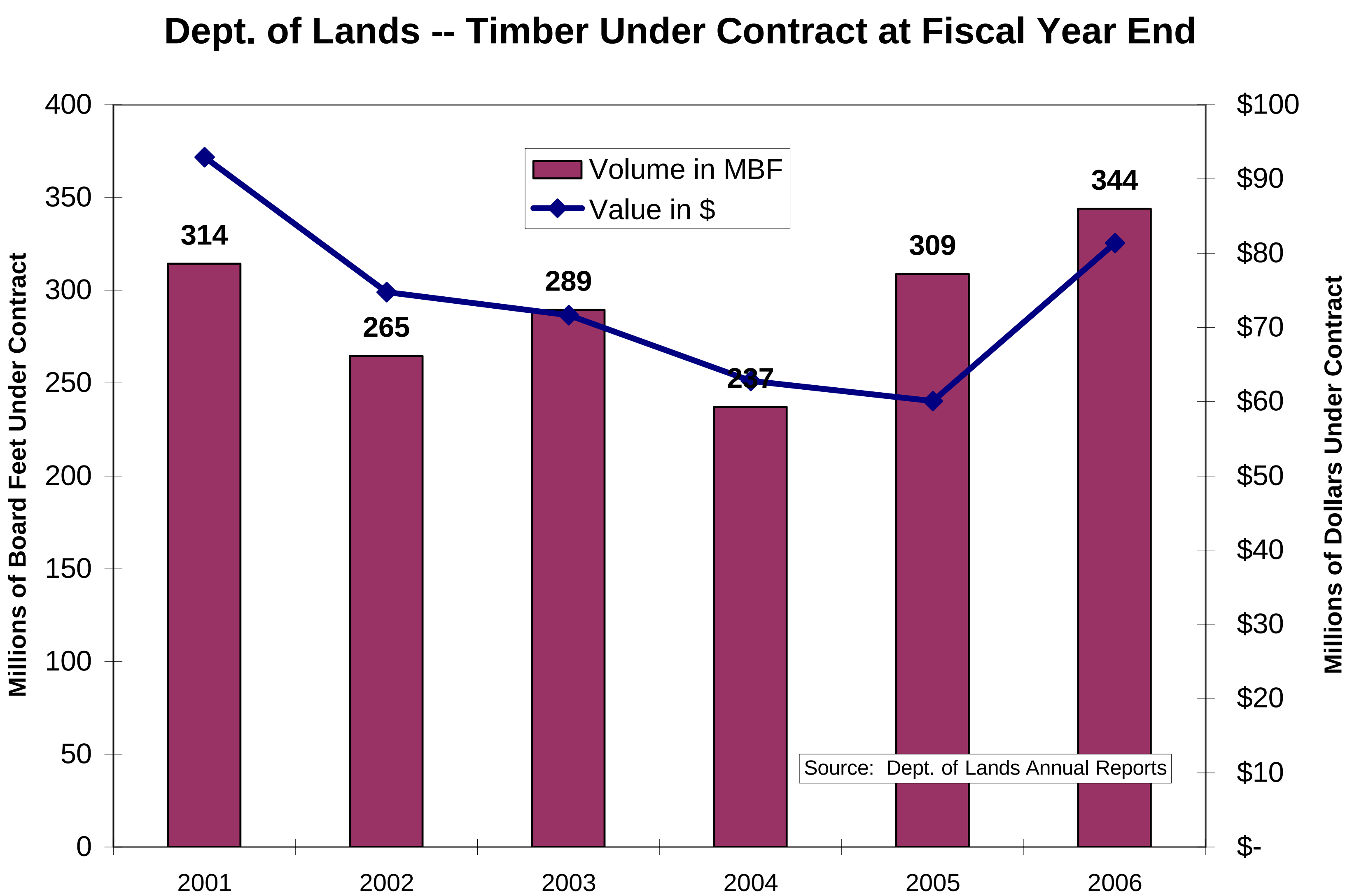
- Strong revenues from Lands in fiscal 2006 result in net cash flow gain of $31 million
- Earnings Reserves grow to record level – $91 million
- FY2007 approved distribution is safe – every fund has reserves in excess of 150%
- Timber bid prices were high in 2006, implying good revenues this year, resulting in further boosts to Earnings Reserves: they should start FY 2008 even stronger

Earnings Reserve Coverage

2006 Reserves as % of 2007 Distributions



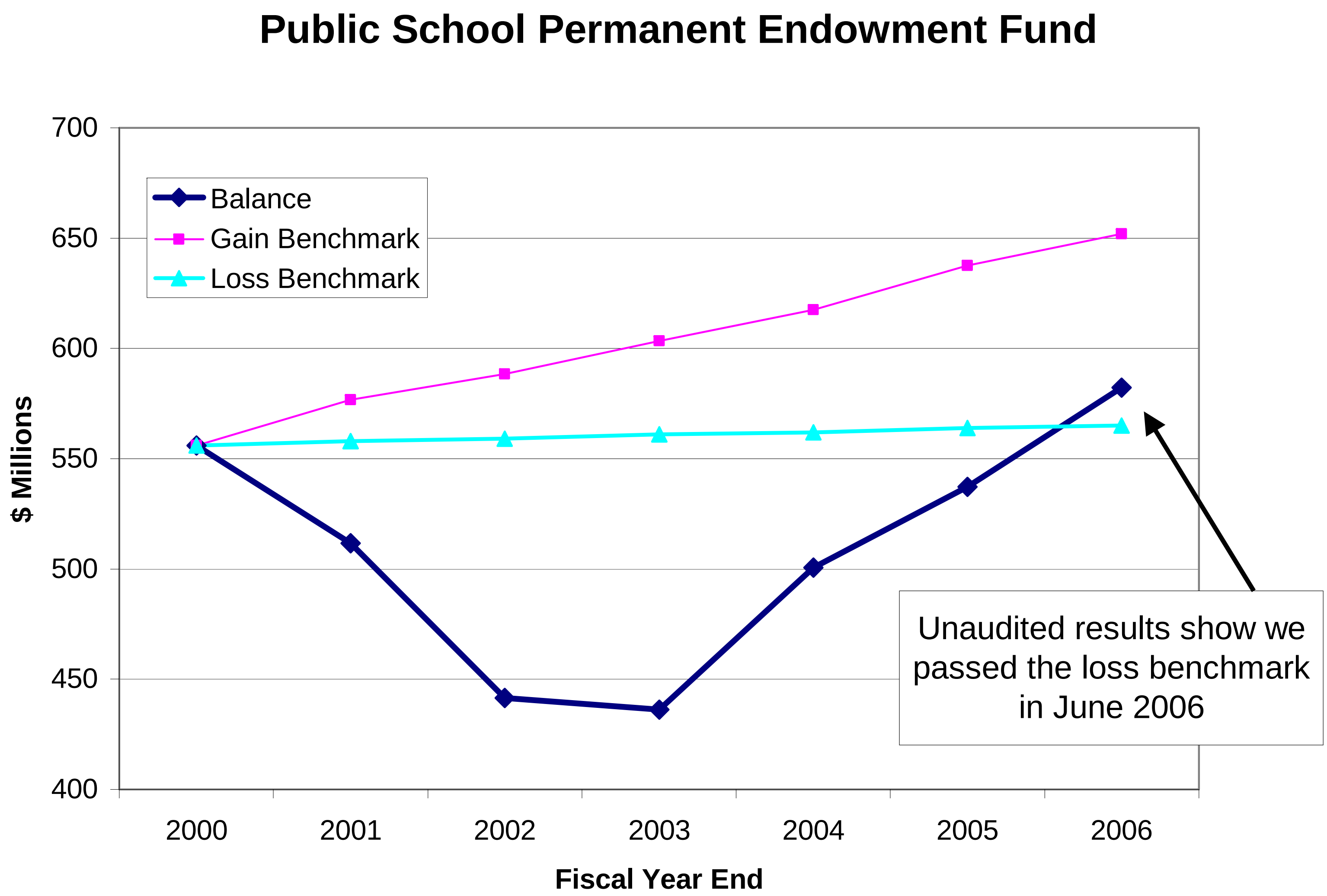
Record pre-sold timber inventory



Lands on target to auction record levels of volume (212 MBF/yr) beginning in 2007

Other Good News

(pending audit confirmation)



Historical Cash Flow Summary

Total Endowment Cash Flows

(millions of dollars)

	2001	2002	2003	2004	2005	2006	2007 Forecast	Average
Beginning Value Earnings Reserve	26	41	21	19	33	54	99	
Net Land Revenues	49	42	35	50	38	47	50	43
Net EFIB Income	30	15	12	14	17	19	20	15
Change in Market Value	(5)	(8)	9	5	4	6	-	2
Distributions to beneficiaries	(58)	(70)	(57)	(55)	(37)	(36)	(36)	
Ending Earnings Reserves Fund	41	21	19	33	54	91	133	
Total Revenues/Market	74	49	56	69	58	73	70	61
Net after distributions	15	(20)	(1)	14	21	37	34	

Total revenues have exceeded distributions for three consecutive years and are likely to do so again this fiscal year.

Earnings Reserves are at record levels and expected to continue to grow in FY2007

Enhancements to the Policy

The proposed Policy provides the following enhancements:

- Recognizes the unique aspects of each endowment fund
  - Variability of income
  - Current level of Earnings Reserves
- Pegs distributions to recent levels of revenues
- Builds in sufficient safety to allow distributions to continue during cyclical downturns in endowment revenues
- Provides an additional margin of safety to give the Land Board and the Legislature at least two years to respond to a drastic impairment in endowment earning power

Challenges with the proposed Spending Policy

- It is complex and has not been fully vetted by EFIB staff or the Reform Review Task Force
- Therefore, not asking the Land Board to approve the policy at the August 8 meeting, only for approval of the FY2008 distributions resulting from the policy
- The Investment Board will provide their opinion by Aug. 8th on whether they believe the proposed distributions are prudent from a fiduciary standpoint

Considerations in setting distributions

- Spendable funds can only come from earnings from the land or returns from the stocks and bonds
  - Permanent funds, adjusted for inflation, can never be spent
  - Changes in earnings must eventually impact spending
- Earnings Reserve fund must absorb volatility in:
  - Interest rates (return on fixed income)
  - Stock market returns (dividends and capital gains)
  - Revenues from state lands (variation in the rate of timber harvest and the price of timber)
- A balancing act: Every dollar in current year distributions increases the likelihood of a decrease in future distributions

How much risk of a future shortfall do we want to take?

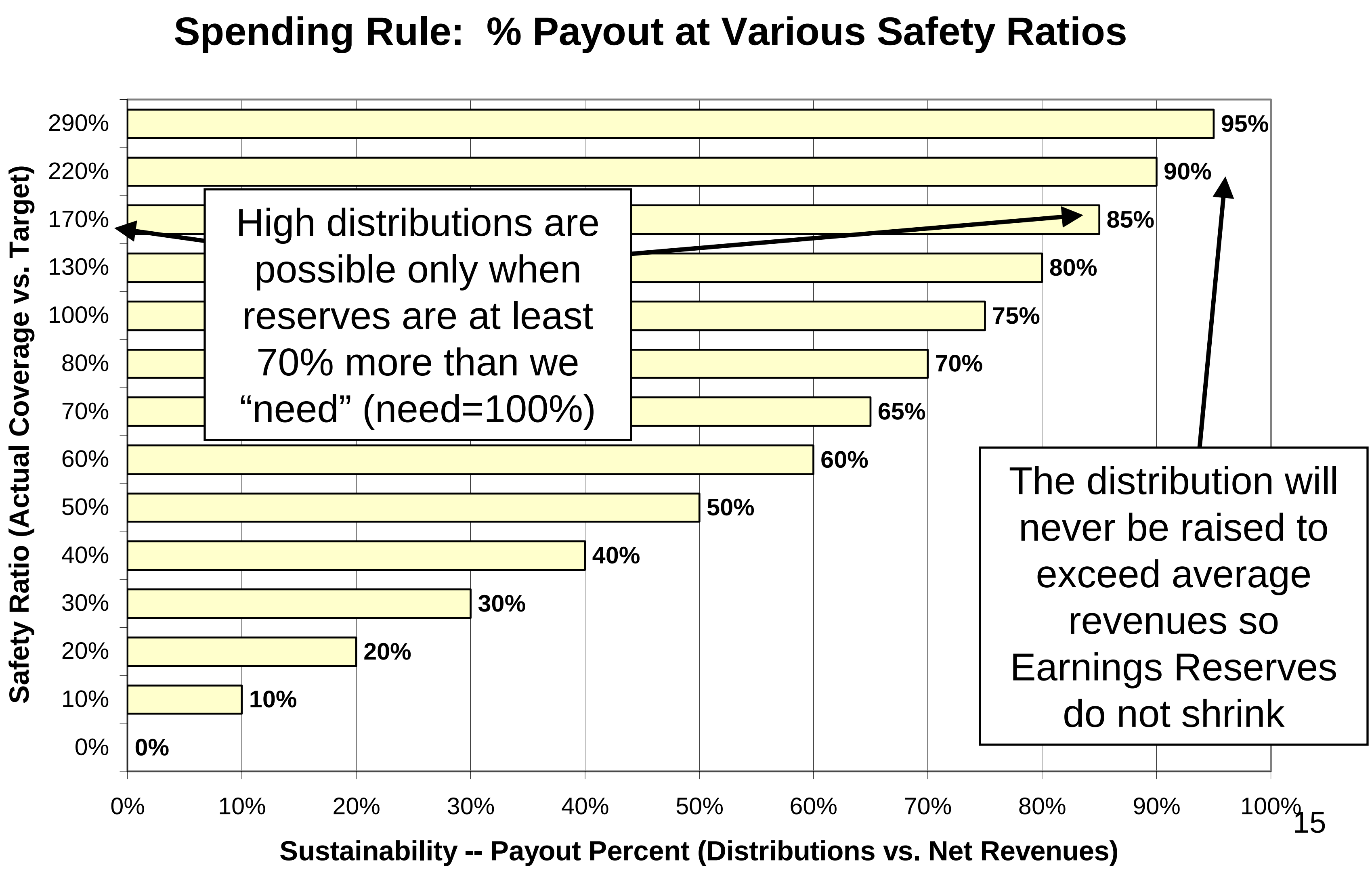
Drivers of the proposed policy

- Looks at both a measure of the “sustainability” of distributions and a measure of the “safety” of the distribution
- Sustainability is based on the payout of revenues – a distribution in excess of revenues is unsustainable
- Safety is based on the amount in earnings reserve relative to the amount “needed” to cushion volatility in revenues

How the proposed policy works

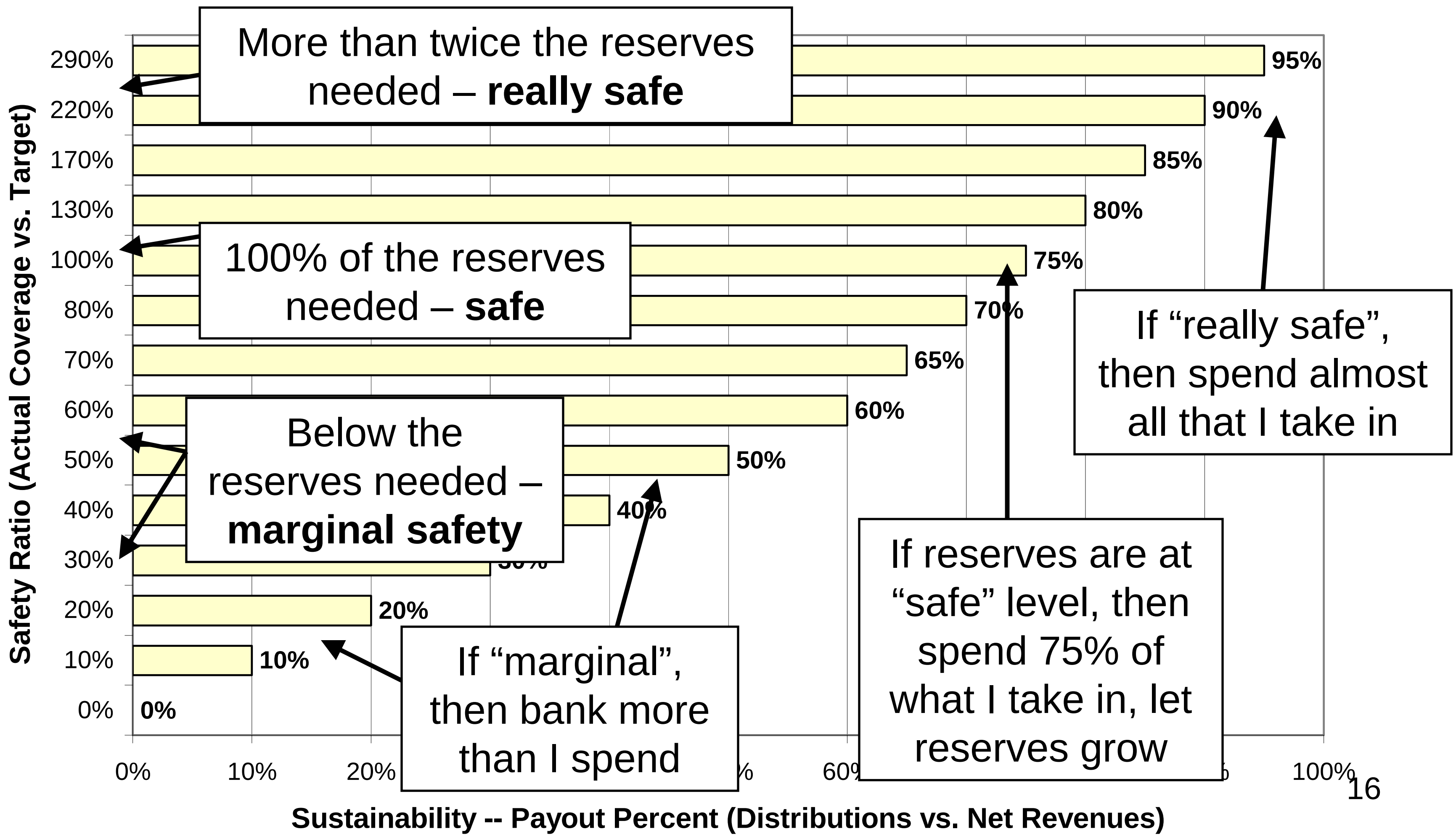
- The higher Earnings Reserve are (safety coverage), the more distributions can be raised
- However, distributions will never be raised until they equal or exceed historical net revenues (which would likely be unsustainable)
  - Paying out <100% provides continued growth in reserves or a buffer if earnings fall temporarily
- If earnings deteriorate a little, the safety coverage allows distributions to be held at current levels until earnings rebound
- If earnings deteriorate a lot, then distributions can be gradually reduced before reserves are fully depleted

Safety and Sustainability: proposed Spending Policy in graphic form



Safety and Sustainability: another way to look at the Policy

Spending Rule: % Payout at Various Safety Ratios



Result of the proposed "safe & sustainable" Spending Policy

- Approved 2007 distribution = **$35 million**
- Scenario 1: "Safe" levels of coverage, FY2008 = **$52 million**
  - 5 endowments increase, 2 hold steady, 1 declines 10%
  - FY2009 = $55 million, FY2010 = $58 million
- "Safer" levels, FY 2008 = **$47 million**
  - 3 endowments increase, 3 hold steady, 2 decline 10%
  - FY2009 = $50 million, FY2010 = $53 million

Spending Summary By Endowment Fund

	Public Schools	Ag College	Charit-able Insti-tutions	Normal School	Peniten-tiary	School of Science	State Hospital South	Univer-sity	Grand Total
Proposed Distributions									
					(Millions of Dollars)				
2007 Distribution (approved)	(24.648)	(0.661)	(2.361)	(2.116)	(0.809)	(2.376)	(1.052)	(1.823)	(35.846)
2008 Distribution (proposed - "Safe" Scenario)	(36.815)	(0.661)	(2.564)	(2.841)	(0.728)	(2.376)	(3.678)	(2.645)	(52.308)
Change in distribution - $ (Increase)Decrease vs. 2007	(12.167)	0.000	(0.203)	(0.725)	0.081	0.000	(2.627)	(0.822)	(16.463)
Change in distribution - % Increase(Decrease) vs. 200	***49%***	***0%***	***9%***	***34%***	***-10%***	***0%***	***250%***	***45%***	***46%***
2008 Distribution (proposed - "Safer" Scenario)	(32.484)	(0.661)	(2.361)	(2.506)	(0.728)	(2.138)	(3.678)	(1.949)	(46.507)
Change in distribution - $ (Increase)Decrease vs. 2007	(7.836)	0.000	0.000	(0.391)	0.081	0.238	(2.627)	(0.126)	(10.661)
Change in distribution - % Increase(Decrease) vs. 200	***32%***	***0%***	***0%***	***18%***	***-10%***	***-10%***	***250%***	***7%***	***30%***
Measures of Safety									
Earnings Reserve Balances									
Actual 2006 (with dedicated fund transfer)	64.7	2.4	6.1	5.4	1.3	3.9	9.2	6.2	99.2
Forecasted 2007	86.6	2.6	5.9	8.2	2.6	8.6	13.0	9.4	136.9
Forecasted 2008	91.2	4.1	6.7	9.7	3.2	12.7	15.1	12.0	154.8
Absolute Earnings Reserve Coverage									
Actual 2006 Earnings Reserve Coverage of 2007 Distrib.	263%	368%	259%	256%	157%	162%	877%	338%	277%
Target Earnings Reserve Coverage									
"Safe" Scenario	150%	380%	170%	150%	310%	240%	180%	250%	172%
"Safer" Scenario	250%	480%	270%	250%	410%	340%	280%	350%	272%
Measures of Sustainability									
					(Millions of Dollars)				
Three-year Average Net Revenues									
2004-2006 Actual	43.3	0.9	3.2	3.3	1.1	3.2	3.9	2.8	61.7
Payout Ratios (as a % of three years ended 2006 Net Revenues)									
2007 Approved Distribution as % of Net Revenues	57%	72%	74%	63%	74%	75%	27%	65%	58%
2008 Proposed Distribution as % of Net Revenues									
"Safe" Scenario	85%	72%	80%	85%	67%	75%	95%	95%	85%
"Safer" Scenario	75%	72%	74%	75%	67%	68%	95%	70%	75%

Recommendations to the Land Board from EFIB Staff

Assuming confirmation from the Endowment Fund Investment Board:

- Approve distributions by beneficiary as stated in “Safe” or “Safer” scenario
- Defer approval of the proposed Spending Policy pending further testing and examination by the Reform Review Task Force and the Investment Board

Recommendations of the Endowment Fund Investment Board

Prepared for:

Board of Land Commissioners Meeting

August 8, 2006

Additional Option

- At its meeting yesterday, the Endowment Fund Investment Board recommended that besides the $46.5 million “Safer” scenario that the Land Board also consider a $38.6 million alternative option based on the existing Spending Policy of 5% of the last three years’ Permanent Fund balance
  - Except, Penitentiary and School of Science would have the same lower distribution as specified in the “Safer” scenario

Two EFIB Scenarios

Proposed Distributions

	Public Schools	Ag College	Charit-able Insti-tutions	Normal School	Peniten-tiary	School of Science	State Hospital South	Univer-sity	Grand Total
				(Millions of Dollars)					
2007 Distribution (approved)	(24.648)	(0.661)	(2.361)	(2.116)	(0.809)	(2.376)	(1.052)	(1.823)	(35.846)
2008 Distribution (existing 5% Policy, ex Pen., Sch Sci.)	(26.995)	(0.725)	(2.582)	(2.310)	(0.728)	(2.138)	(1.149)	(1.990)	(38.617)
Change in distribution - $ (Increase)Decrease vs. 2007	(2.347)	(0.064)	(0.221)	(0.194)	0.081	0.238	(0.097)	(0.167)	(2.771)
Change in distribution - % Increase(Decrease) vs. 200	***10%***	***10%***	***9%***	***9%***	***-10%***	***-10%***	***9%***	***9%***	***8%***
2008 Distribution (proposed - "Safer" Scenario)	(32.484)	(0.661)	(2.361)	(2.506)	(0.728)	(2.138)	(3.678)	(1.949)	(46.507)
Change in distribution - $ (Increase)Decrease vs. 2007	(7.836)	0.000	0.000	(0.391)	0.081	0.238	(2.627)	(0.126)	(10.661)
Change in distribution - % Increase(Decrease) vs. '07	***32%***	***0%***	***0%***	***18%***	***-10%***	***-10%***	***250%***	***7%***	***30%***
As % of Permanent Fund - (vs. existing 5% policy)	*6.0%*	*4.6%*	*4.6%*	*5.4%*	*4.1%*	*4.1%*	*16.0%*	*4.9%*	*6.0%*
"Safer" Scenario (Increase)Decrease vs. Existing 5% Policy									
(in millions of dollars)	(5.489)	0.064	0.221	(0.196)	0.000	0.000	(2.529)	0.041	(7.890)
% Increase(Decrease) vs. Existing 5% Policy	*20.3%*	*-8.8%*	*-8.5%*	*8.5%*	*0.0%*	*0.0%*	*220.2%*	*-2.1%*	*20.4%*

Measures of Safety

	Public Schools	Ag College	Charit-able Insti-tutions	Normal School	Peniten-tiary	School of Science	State Hospital South	Univer-sity	Grand Total
Earnings Reserve Balances									
Actual 2006 (with dedicated fund transfer)	64.7	2.4	6.1	5.4	1.3	3.9	9.2	6.2	99.2
Forecasted 2007	86.6	2.6	5.9	8.2	2.6	8.6	13.0	9.4	136.9
Actual 2006 Earnings Reserve Coverage of 2007 Distrib.	263%	368%	259%	256%	157%	162%	877%	338%	277%
Actual 2006 Earnings Reserve Coverage of 2008 Distrib.									
Existing Policy, except Penitentiary, School of Science	240%	336%	237%	235%	175%	180%	803%	310%	257%
Proposed Policy - "Safer" Scenario	199%	368%	259%	216%	175%	180%	251%	316%	213%
"Needed" level of coverage per proposed policy									
"Safer" Scenario	250%	480%	270%	250%	410%	340%	280%	350%	272%

Measures of Sustainability

	Public Schools	Ag College	Charit-able Insti-tutions	Normal School	Peniten-tiary	School of Science	State Hospital South	Univer-sity	Grand Total
				(Millions of Dollars)					
Three-year Average Net Revenues ('04-'06 Actual)	43.3	0.9	3.2	3.3	1.1	3.2	3.9	2.8	61.7
Payout Ratios (as a % of three years ended 2006 Net Revenues)									
2007 Approved Distribution as % of Net Revenues	57%	72%	74%	63%	74%	75%	27%	65%	58%
2008 Proposed Distribution as % of Net Revenues									
Existing Policy, except Pen., School of Science	62%	79%	81%	69%	67%	68%	30%	71%	63%
"Safer" Scenario	75%	72%	74%	75%	67%	68%	95%	70%	75%

Background on the "Gain Benchmark"

- All of the endowments are below the "gain benchmark" – the inflation-adjusted balance designed to protect the spending power of future generations (see Public School Fund on page 8)
- If below the benchmark, then only interest and dividends flow to Earnings Reserve
  - About 2.5% per year
  - Capital gains must be retained
- Above the benchmark, Total Return in excess of inflation flows to Earnings Reserve
  - Expect 4%-5% per year over a market cycle

Shortfall from Gain Benchmark

FY 2006 -- Unaudited Estimate

	$MM	%
State Hosp. South	(2.9)	-11.8%
Ag College	(1.8)	-11.9%
Normal School	(6.2)	-12.5%
Penitentiary	(2.4)	-12.8%
Public Schools	(78.9)	-13.6%
School of Science	(8.6)	-15.4%
Charitable Instit.	(8.6)	-15.5%
University	(7.0)	-16.5%
Total	(116.6)	-13.8%

Ways to Hit the “Gain Benchmark”

- A transfer from Earnings Reserve to the Permanent Fund could restore the corpus to its inflation-adjusted gain benchmark
- Without a transfer, capital gains are expected to boost the permanent funds to their gain benchmarks within six to nine years
- Currently, there is no policy on when one should transfer from Earnings Reserve to the Permanent Fund
  - Caution: such a transfer moves assets from a spendable fund to an illiquid one

Benefits of the Additional Option

Choosing a smaller increase in distributions (mainly for Public Schools and State Hospital South) offers the following benefits:

- About $7 million more in funds available to transfer to the Permanent Fund to protect purchasing power of the corpus, allow capital gains to flow to Earnings Reserve
- Additional downside protection from market downturns or hiccups in land revenues

Spending Policy History and Options

Fiscal Year Adopted	*Fiscal Year Begin*	*Time In Force*	Public Schools	Ag College	Charitable Institutions	Normal School	Penitentiary	School of Science	State Hospital South	University
			Spending Rate as a % of the Permanent Fund							
2000		1 year	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%	8.5%
2001	2002	1 year	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
2002	2003	2 years*	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%
2004	2007	3 years	5.0%							
2004	2005	1 year		7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%
2005	2006	5 months		6.0%	6.0%	6.0%	6.0%	6.0%	6.0%	6.0%
2005	2006	7 months		0.0%	0.0%	8.1%	16.2%	6.4%	26.9%	10.2%
2006	2007	1 year		5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
2007	**2008**	**Proposed**								
	Existing**		**5.0%**	**5.0%**	**5.0%**	**5.0%**	**4.1%**	**4.1%**	**5.0%**	**5.0%**
	"Safer" scenario		**6.0%**	**4.6%**	**4.6%**	**5.4%**	**4.1%**	**4.1%**	**16.0%**	**4.9%**

* Shortfall in the Public School Endowment Fund in FY2003 resulted in actual payout of 6.45%

** Except for Penitentiary and School of Science

Recommendations to the Land Board from the EFIB

- Approve distributions by beneficiary as stated in the proposed “Safer” scenario ($46.5 million) or the existing Spending Policy ($38.6 million)
- Defer approval of the proposed Spending Policy pending further testing and examination by the Reform Review Task Force and the Investment Board
- Have the Task Force work with the EFIB to determine the advisability of transferring Earnings Reserve to the Permanent Fund

Appendix
Supporting Information for Endowment Fund Spending Policy

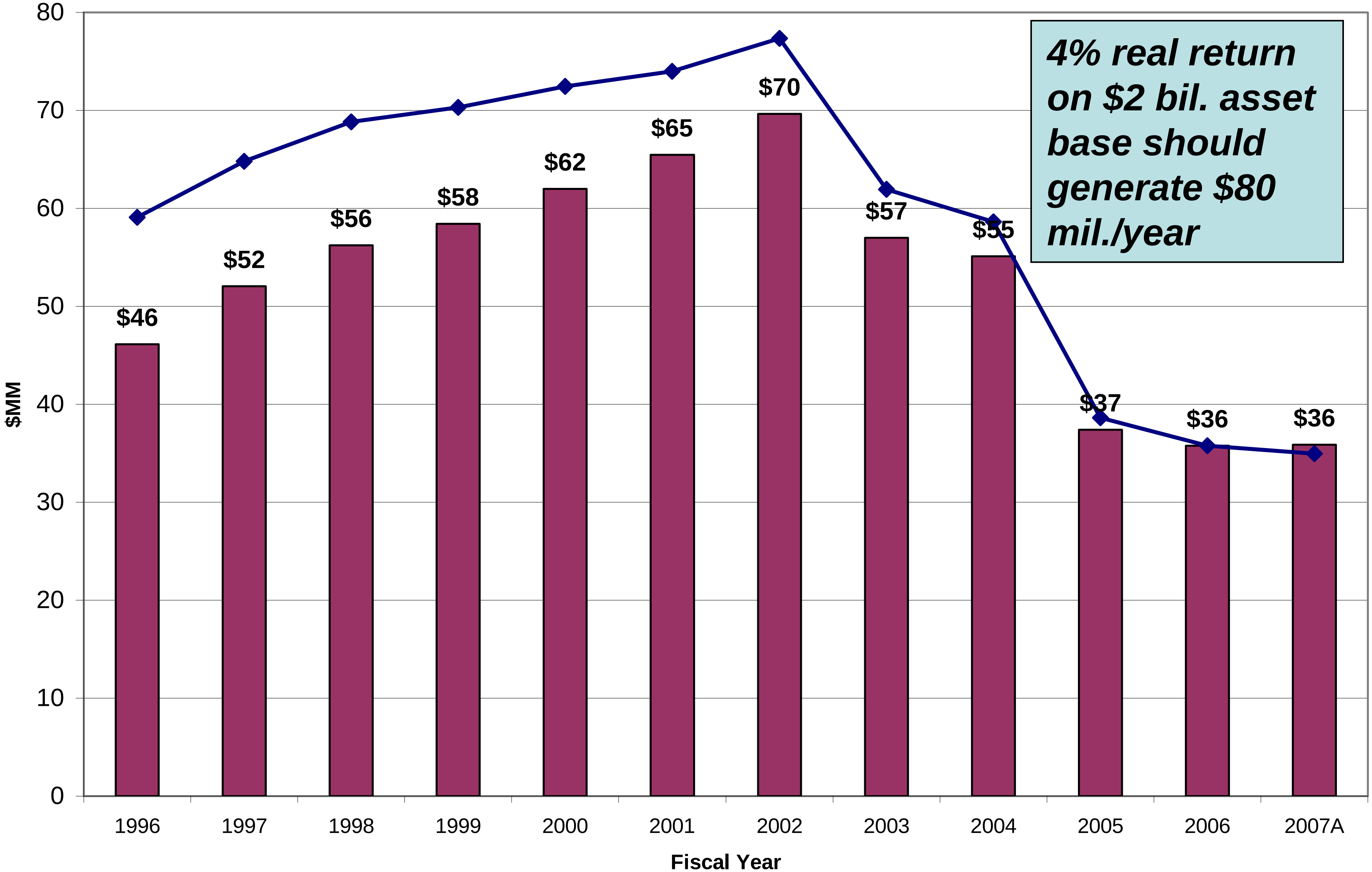
Prepared for:

Board of Land Commissioners Meeting

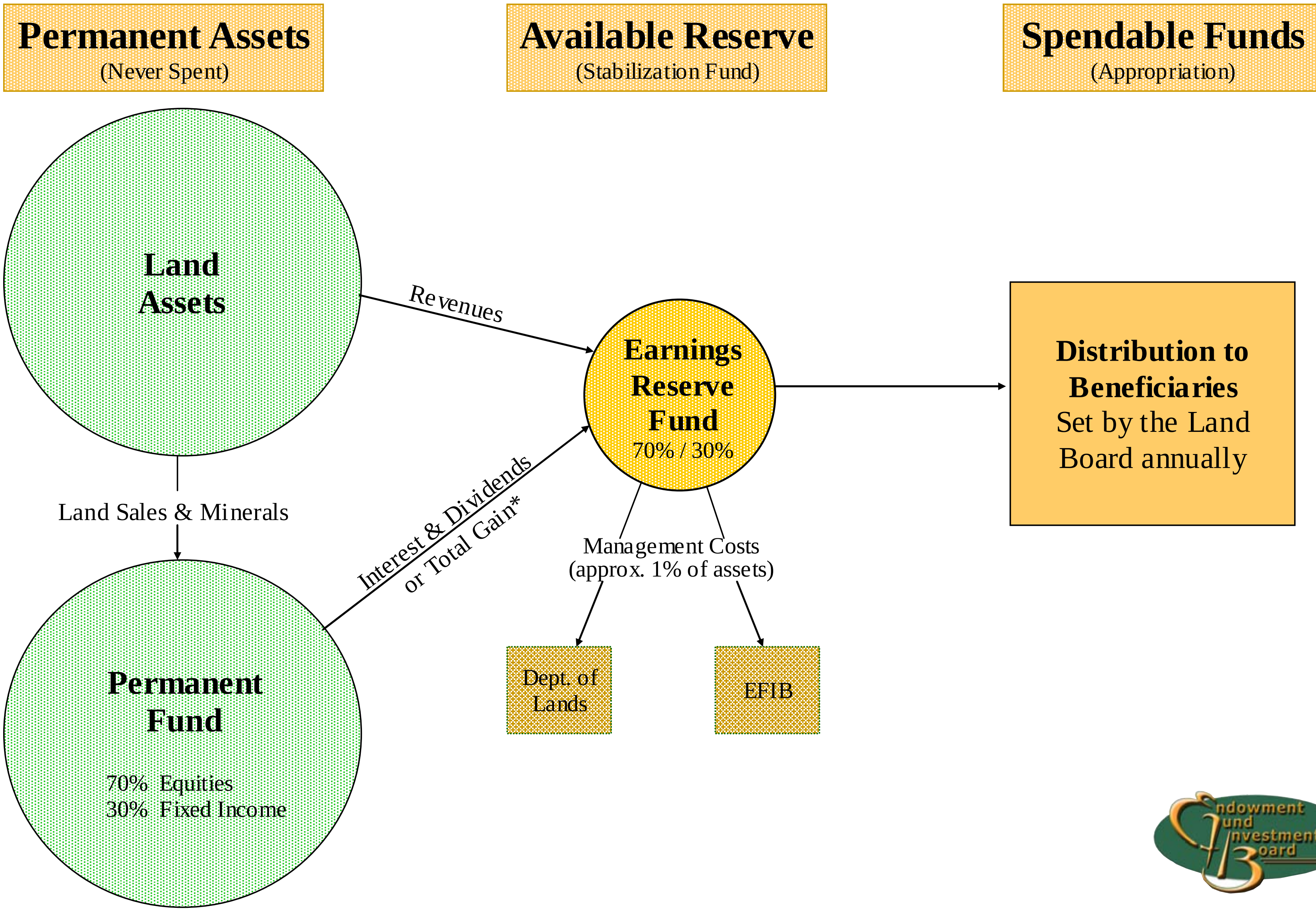
August 8, 2006

Total Endowment Distributions To Beneficiaries 1996 to 2007
Actual and Inflation-Adjusted (in 2006 $)

(Net of General Fund Contribution in 2006 of $4.6MM)



STRUCTURE OF IDAHO'S ENDOWMENT ASSETS



* *When the Permanent Fund, adjusted for inflation, exceeds its June 2000 level, only total gain over inflation will be distributed to Earnings Reserve.*

Considerations in setting distributions

- Spendable funds can only come from earnings from the land or returns from the stocks and bonds
  - Permanent funds, adjusted for inflation, can never be spent
  - Changes in earnings must eventually impact spending
- Earnings Reserve fund must absorb volatility in:
  - Interest rates (return on fixed income)
  - Stock market returns (dividends and capital gains)
  - Revenues from state lands (variation in the rate of timber harvest and the price of timber)
- A balancing act: Every dollar in current year distributions increases the likelihood of a decrease in future distributions

How much risk of a future shortfall do we want to take?

Current Spending Policy

- Based only on % of Permanent Endowment Funds
- Does not reflect limitation of only spending from Earnings Reserve
- Is not customized to each “Pooled Fund” endowment
  - Earning capability of unique land asset
  - Current reserve balances

The Permanent component of fund value varies

Components Of Value
By Endowment Fund

	Permanent ***Fund***	*Earnings* ***Reserve***	*Land Value* ***(estim.)***
Penitentiary	51%	3%	46%
School of Science	50%	3%	46%
Charitable Institutions	48%	5%	47%
Ag College	46%	7%	47%
University	44%	6%	49%
Normal School	44%	5%	51%
Public Schools	40%	4%	55%
State Hospital South	22%	8%	70%
Total Endowments	41%	5%	54%

New Policy: Conceptual Framework

- Over long periods, Distributions = Net Revenues (payout ratio)
- Because of volatility in Net Revenues, need Earnings Reserves to dampen swings (coverage ratio)
- Therefore, Spending Policy should be based on combination of long-term **sustainability** (payout) and short-term **safety** (coverage) for each beneficiary

Key Formulas

$$\frac{\text{Current Year Distributions}}{\text{3-Yr. average Net Revenues}} \quad \text{| Payout Ratio}$$

$$\frac{\text{Prev. Yr. Earnings Reserve}}{\text{Current (or Next) Yr. Distributions}} \quad \text{| Coverage Ratio}$$

Maximum % volatility of Net Revenue | Target Coverage Ratio

$$\frac{\text{Coverage Ratio}}{\text{Target Coverage Ratio}} \quad \text{| Safety Ratio}$$

Examples

			Example Number:		
	Assumptions:		**One**	**Two**	**Three**
	Net Revenue		$100	$100	$300
	Earnings Reserve		$100	$100	$100
	Distribution		$200	$50	$150
Payout Ratio	Current Year Distribtutions / 3 Yr. Ave Net Revenue		$200 / $100	$50 / $100	$150 / $300
		=	*200%*	*50%*	*50%*
Coverage Ratio	Previous Year Earnings Reserve / Current Year Distributions		$100 / $200	$100 / $50	$100 / $150
		=	*50%*	*200%*	*67%*
Target Coverage	Maximum % Volatility of Net Revenue	=	*50%*	*100%*	*200%*
Safety Ratio	Coverage Ratio / Target Coverage Ratio		50% / 50%	200% / 100%	67% / 200%
		=	*100%*	*200%*	*33%*

Applying “Safe and Sustainable” to Spending Policy

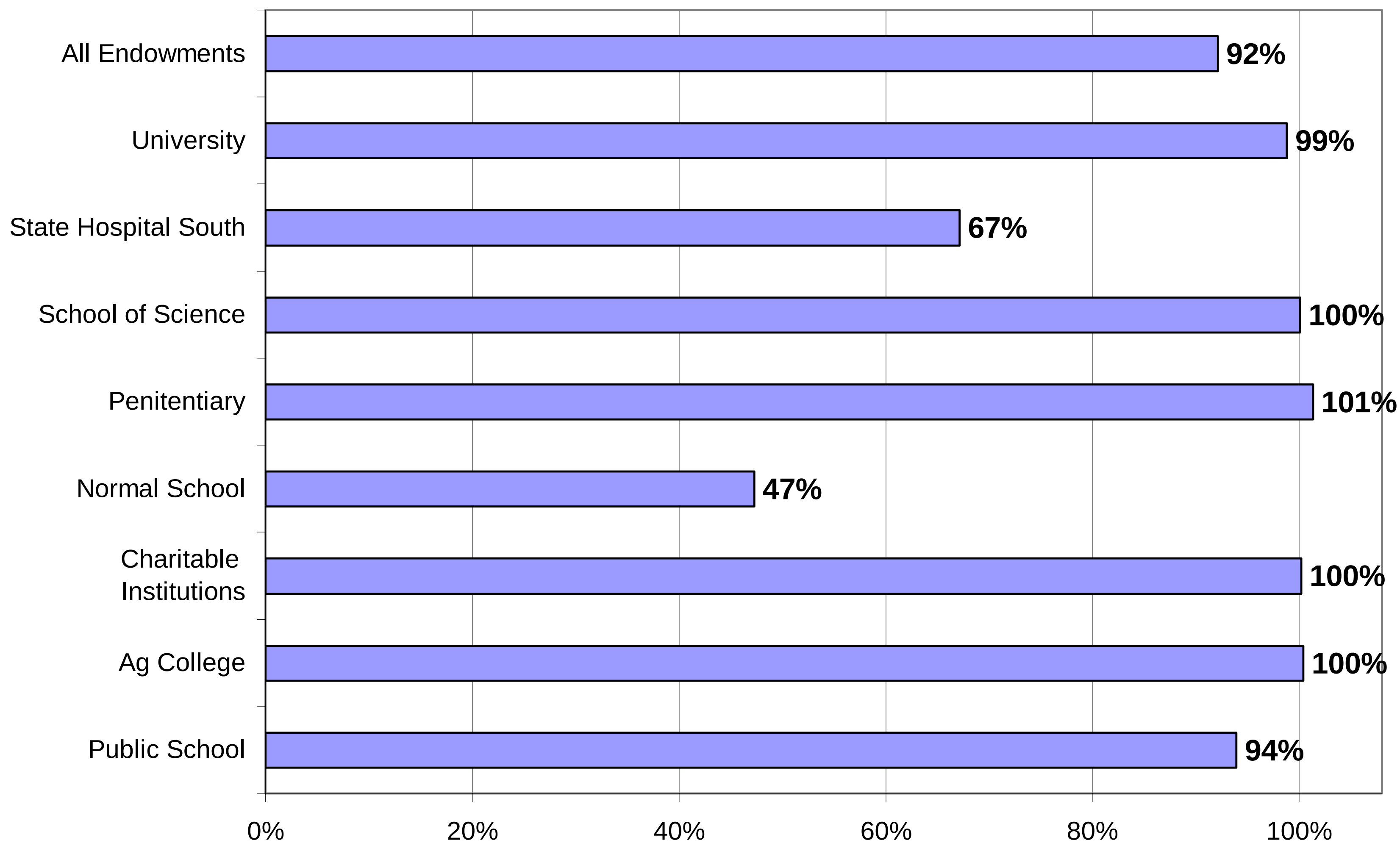
	Safety (Safety Ratio: Actual Coverage vs. Target)			
Sustainability (Payout Ratio)	**Low** < 90%	**OK** 90%-120%	**High** 120%-200%	**Very High** >200%
Weak Payout >100%	Cut	Cut or Hold	Hold	Hold
Average 80%-100%	Cut or Hold	Hold	Hold or Raise	Raise
Strong Payout <80%	Hold	Hold or Raise	Raise	Raise

Conceptual example

Setting Safety Levels

- If we can determine how much Net Earnings will go down during a cycle, we will know how much to hold in reserve to ensure stability of distributions (the target coverage ratio)
- Chances are we'll underestimate, so might also add a "failure" factor for unusual disruptions in earnings

% Of Lands Earnings Reserve Income From Timber - FY 2005



Earnings from timberland is the primary source of income for 6 of 8 endowments, and important to the other two.

Only Public Schools has a large forested land base

	Acres of Forested Land			% of
Endowment	***Primary***	***Secondary***	***Total***	***Total***
Public Schools	570,087	183,063	753,150	73%
Charitable Institutions	60,245	996	61,241	6%
School of Science	58,301	2,582	60,883	6%
University of Idaho	41,845	991	42,836	4%
Normal School	40,547	2,116	42,663	4%
State Hospital South	25,753	768	26,521	3%
Penitentiary	26,023	56	26,079	3%
Agricultural College	14,406	96	14,502	1%
Capitol	6,465	336	6,801	1%
Total	843,672	191,004	1,034,676	100%

Source: Idaho Department of Lands 2005 Annual Report

Heavy reliance on timber + small land base = volatility of harvest = volatility of revenues

Normal School and State Hospital South offset small land bases with significant non-timber revenue

	Average Annual Revenues ($ million)	*6-Year Standard Deviation (% of Ave.)*
Normal School	3.3	11%
Public Schools	39.7	12%
Charitable Institutions	2.8	19%
State Hospital South	3.3	21%
School of Science	3.4	42%
University of Idaho	3.2	45%
Penitentiary	1.5	64%
Agricultural College	0.6	88%
Total	56.5	10%

Setting the Target Coverage Ratio

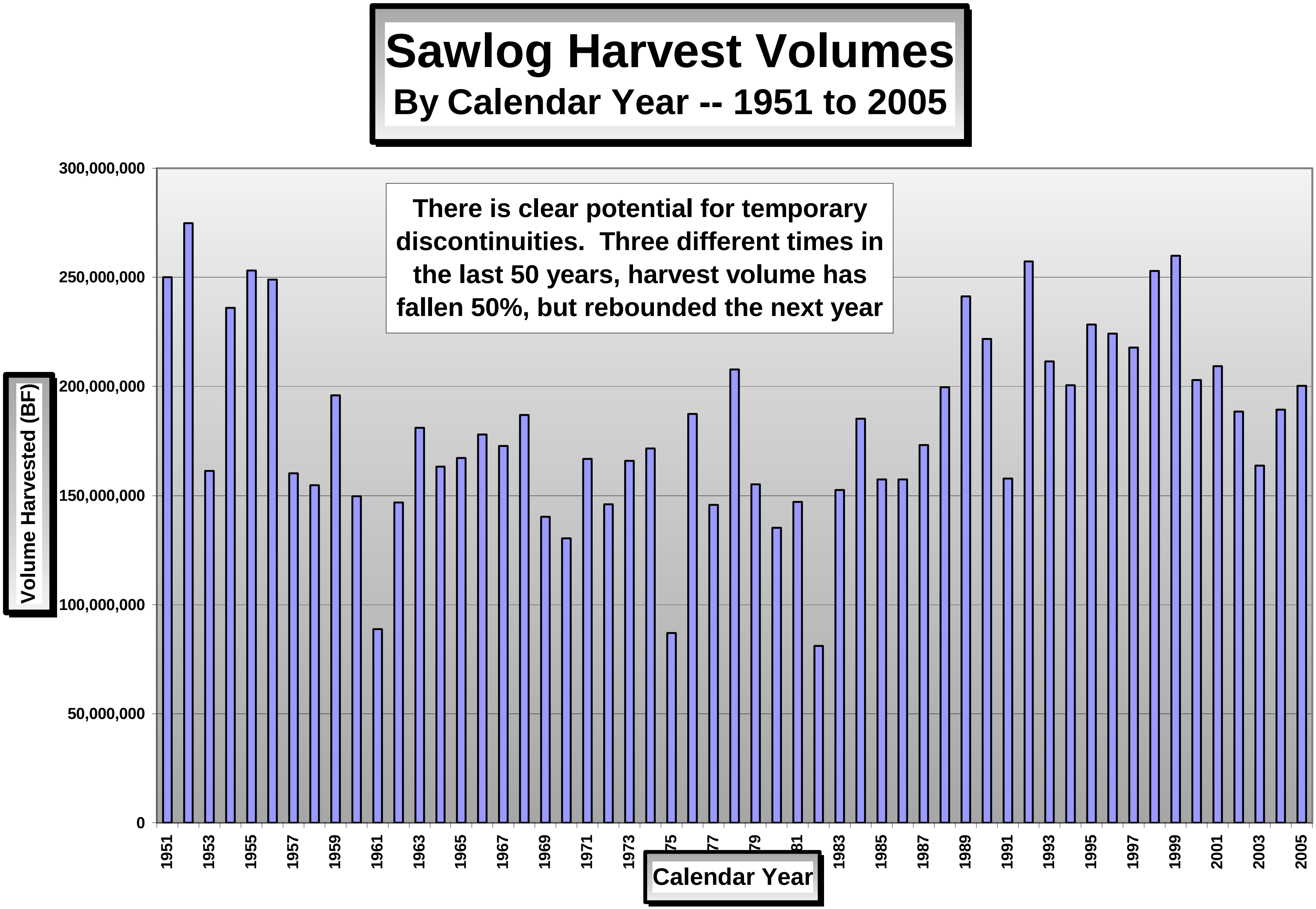
Estimating Required Reserves
Based On Volatility Of Lands Revenue

	Average Annual Revenues ($ million)	*6-Year Standard Deviation (% of Ave.)*	*Triple for likely downside*	*Add 10% for max. likely mkt. downturn*
Normal School	3.3	11%	32%	42%
Public Schools	39.7	12%	35%	45%
Charitable Institutions	2.8	19%	58%	68%
State Hospital South	3.3	21%	62%	72%
School of Science	3.4	42%	126%	136%
University of Idaho	3.2	45%	135%	145%
Penitentiary	1.5	64%	192%	202%
Agricultural College	0.6	88%	265%	275%
Total	56.5	10%		

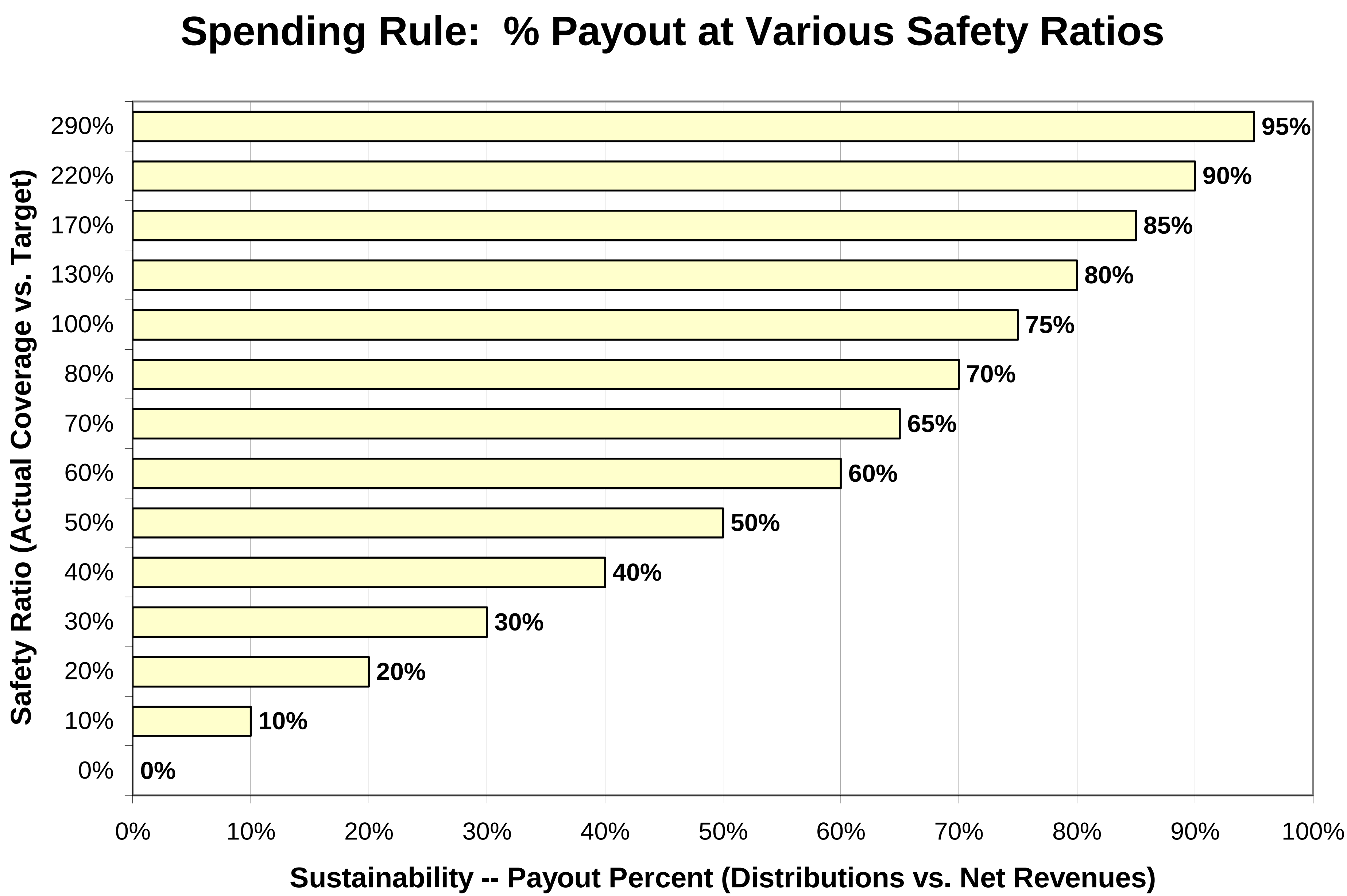
Target Coverage Ratio

Adding further Safety Margin

- In determined proposed distributions, an additional margin was added to the Target Coverage Ratio to provide an extra cushion so that in the event of a permanent (or severe temporary) impairment of assets, distributions can continue thru the approved budget cycle
- Two scenarios: add 100% (Safe scenario) and 200% (Safer scenario) margin to the Target Coverage Ratio computed on the preceding page
- Ensures the Legislature can consider any impairments of endowment distributions as part of the normal appropriation process
- These additional cushions are not enough to protect distributions from eventual decline in a failure scenario (long-term decline in Net Revenues of more than 25%), but they are enough to give at least two year’s warning



Source: Dept. of Lands


Spending Rule: % Payout at Various Safety Ratios
Safety Ratio (Actual Coverage vs. Target)
290%
220%
170%
130%
100%
80%
70%
60%
50%
40%
30%
20%
10%
0%
95%
90%
85%
80%
75%
70%
65%
60%
50%
40%
30%
20%
10%
0%
0%
10%
20%
30%
40%
50%
60%
70%
80%
90%
100%
Sustainability -- Payout Percent (Distributions vs. Net Revenues)

Spending Policy Decision Rules: Sustainability

Distributions will primarily be based on Sustainability

- Distributions will never be raised to more than 95% of Net Revenues (average of past three years), i.e. Payout Ratio ≤ 95%
- While one could distribute 100% over time, we choose not to <u>raise</u> distributions to 100% so there is a cushion to avoid reducing distributions in case Net Revenues drop temporarily in future years

Spending Policy Decision Rules: Safety

Distributions will secondarily be based on Safety

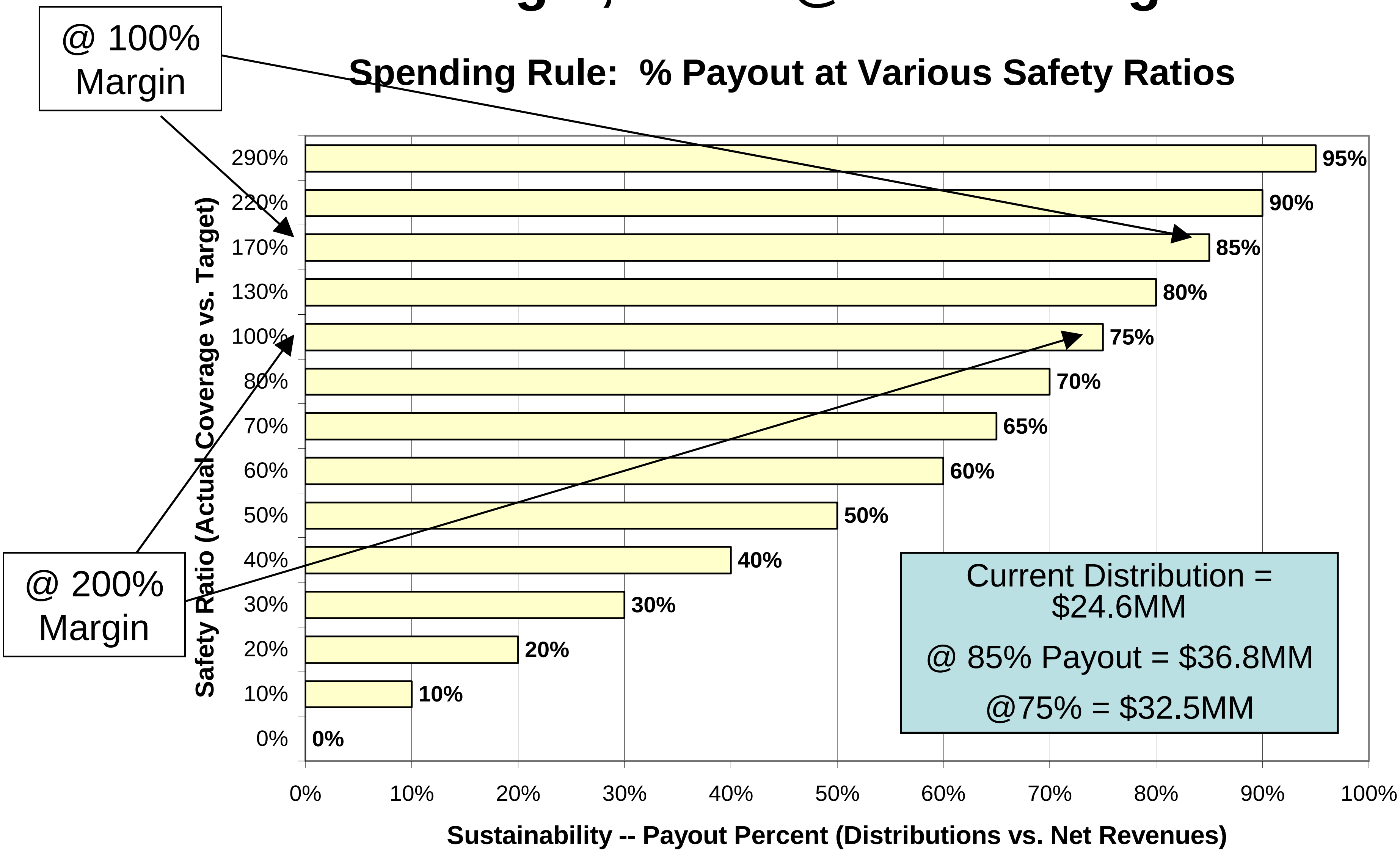
- Distributions, as a percent of Net Revenues, will be increased or decreased based on the Safety Coverage Ratio:
  - Ratio of actual Coverage Ratio to Target Coverage Ratio
- Increase if Payout indicated by Rule > current payout
- Hold if Payout by Rule < current payout, unless:
  - Decrease by 10% if current distribution exceeds Payout indicated by Rule by more than 20%

Spending Policy Calcs For Three Endowments

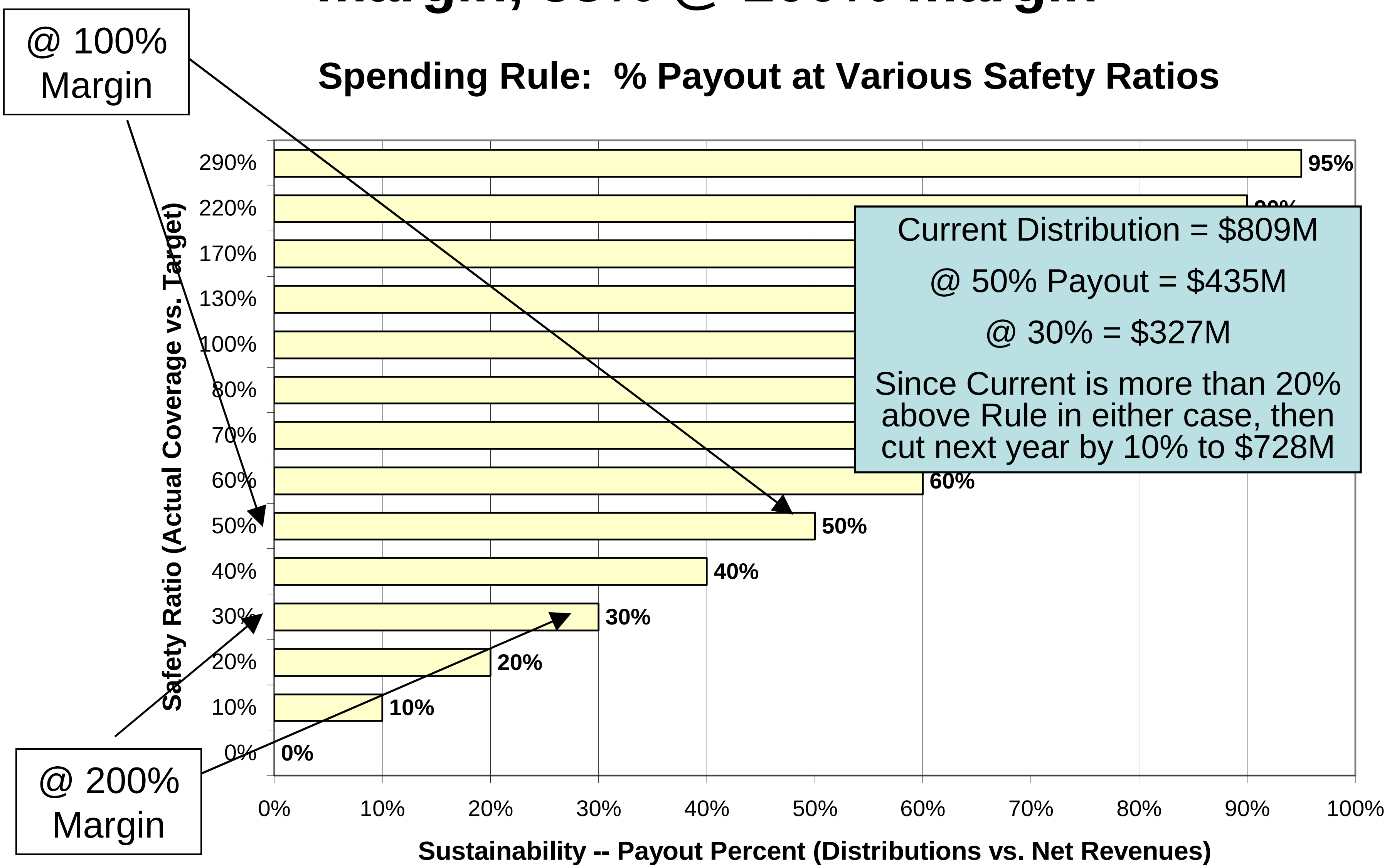
	Key inputs ($MM)		Public School Fund	Peniten-tiary Fund	School of Science Fund
	Net Revenue ("04-'06 3-Yr Ave)		$43.3	$1.1	$3.2
	Earnings Reserve (June 2006)		$64.7	$1.3	$3.9
	Distribution (FY2007)		$24.6	$0.8	$2.4
Payout	Current Year Distribtutions		$24.6	$0.8	$2.4
Ratio	3 Yr. Ave Net Revenue		$43.3	$1.1	$3.2
		=	*57%*	*74%*	*75%*
Coverage	Previous Year Earnings Reserve		$64.7	$1.3	$3.9
Ratio	Current Year Distributions		$24.6	$0.8	$2.4
		=	*263%*	*157%*	*162%*
Target	Maximum % Volatility	*Safe:* =	*150%*	*310%*	*240%*
Coverage	of Net Revenue	*Safer:* =	*250%*	*410%*	*340%*
Safety	Coverage Ratio		263%	157%	162%
Ratio	Target Coverage Ratio (100%)		150%	310%	240%
		Safe: =	*175%*	*51%*	*68%*
Safety	Coverage Ratio		263%	157%	162%
Ratio	Target Coverage Ratio (200%)		250%	410%	340%
		Safer: =	*105%*	*38%*	*48%*

Payout Ratio and Safety Ratio are used to set distributions

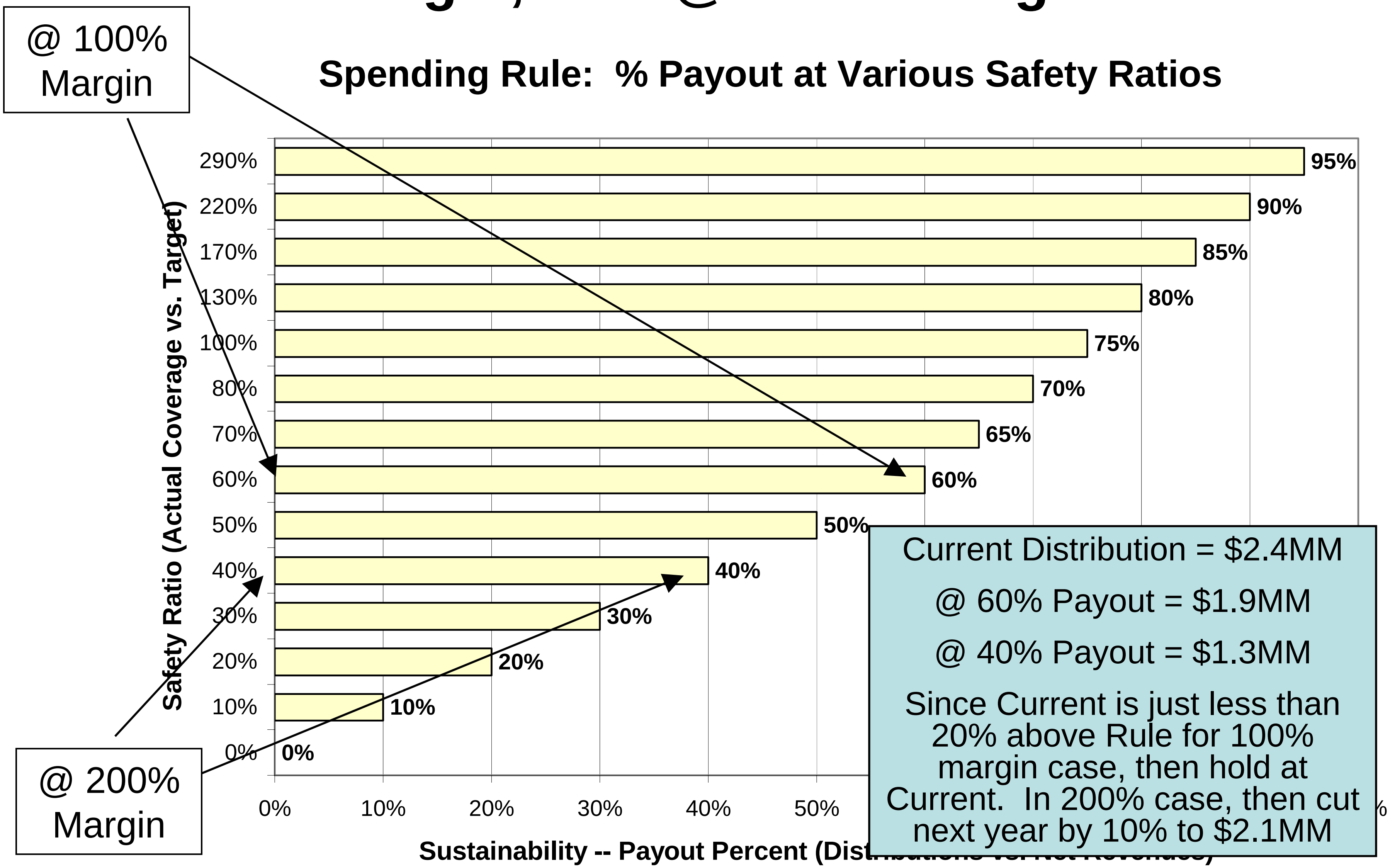
Example: Public Schools Endowment 57% Payout Ratio, Safety Ratio of 175% @ 100% margin, 105% @ 200% margin



Example: Penitentiary Endowment
74% Payout Ratio, Safety Ratio of 51% @ 100% margin, 38% @ 200% margin



Example: School Of Science Endowment
75% Payout Ratio, Safety Ratio of 68% @ 100% margin, 48% @ 200% margin

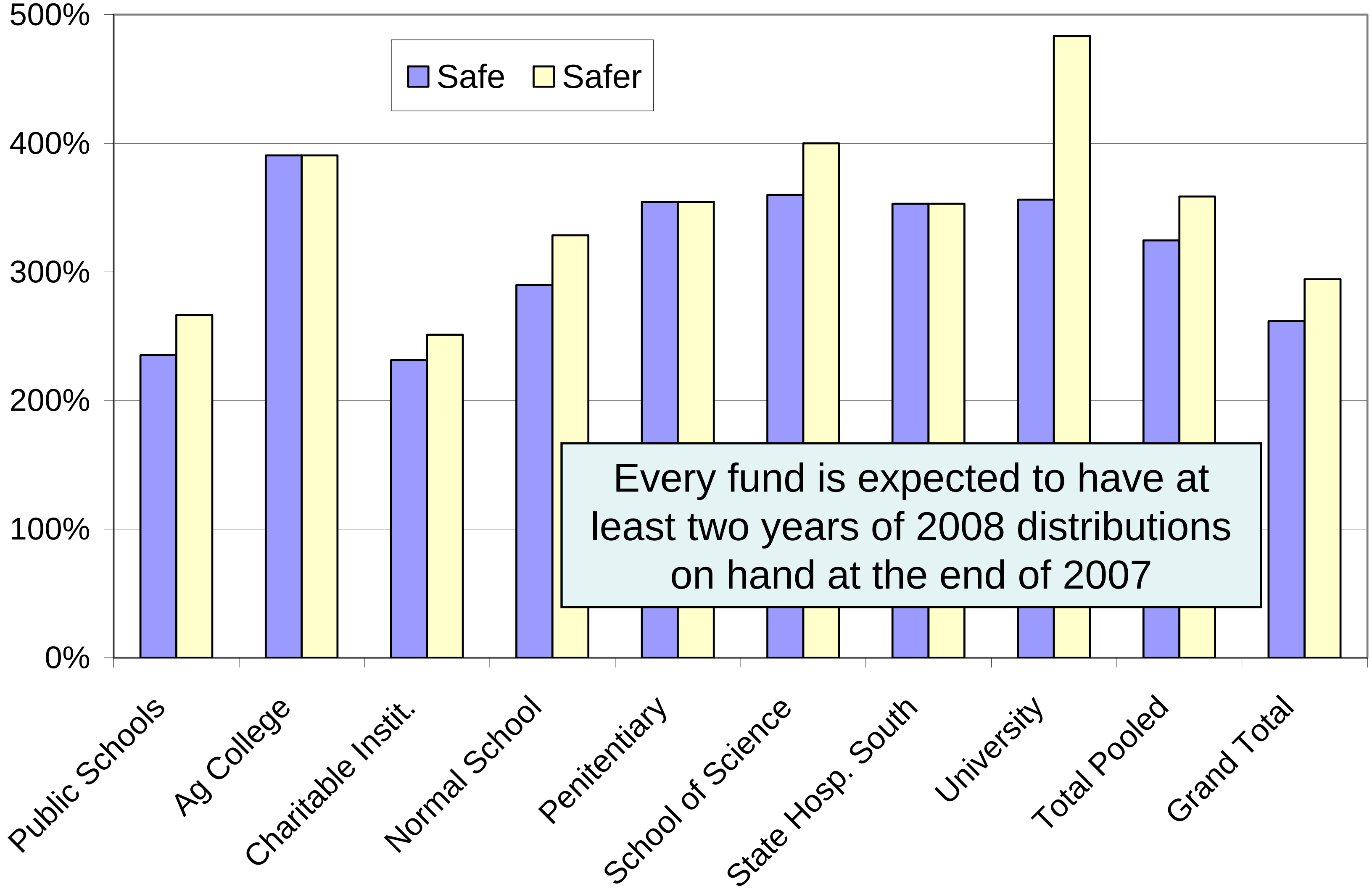


Result of the proposed “safe & sustainable” Spending Policy

- Approved 2007 distribution = **$35 million**
- “Safe” levels of coverage (100% margin), FY2008 = **$52 million**
  - 5 endowments increase, 2 hold steady, 1 declines 10%
  - FY2009 = $55 million, FY2010 = $58 million
- “Safer” levels (200%), FY 2008 = **$47 million**
  - 3 endowments increase, 3 hold steady, 2 decline 10%
  - FY2009 = $50 million, FY2010 = $53 million

Earnings Reserve Coverage

FY2007 Reserves vs. FY2008 Distributions



High Payouts and low Coverage ratios have led to problems in the past

Public Schools Earnings Reserve Fund						***2006***	***2007***	
							8/06	
Fiscal Years	***2001***	***2002***	***2003***	***2004***	***2005***	***Actual***	***Forecast***	***Average***
Beginning Value Earnings Reserve	19	16	3	5	16	32	65	
Net Land Revenues	28	29	24	37	26	33	30	30
Net EFIB Income	20	10	8	10	11	13	13	11
Change in Market Value	(6)	(5)	7	2	2	4	-	2
Distributions to beneficiaries	(45)	(48)	(37)	(38)	(23)	(23)	(25)	
Ending Earnings Reserves Fund	16	3	5	16	32	59	84	
Total Revenues/Market	42	34	39	49	39	50	44	42
Net Change in Earngs Resv.	(3)	(14)	2	11	16	27	19	
Annual Payout Ratio	*94%*	*122%*	*115%*	*81%*	*62%*	*50%*	*56%*	
Coverage Ratio		*40%*	*44%*	*7%*	*20%*	*67%*	*128%*	
Proforma (at $43MM promised 2003 distribution)			*37%*					

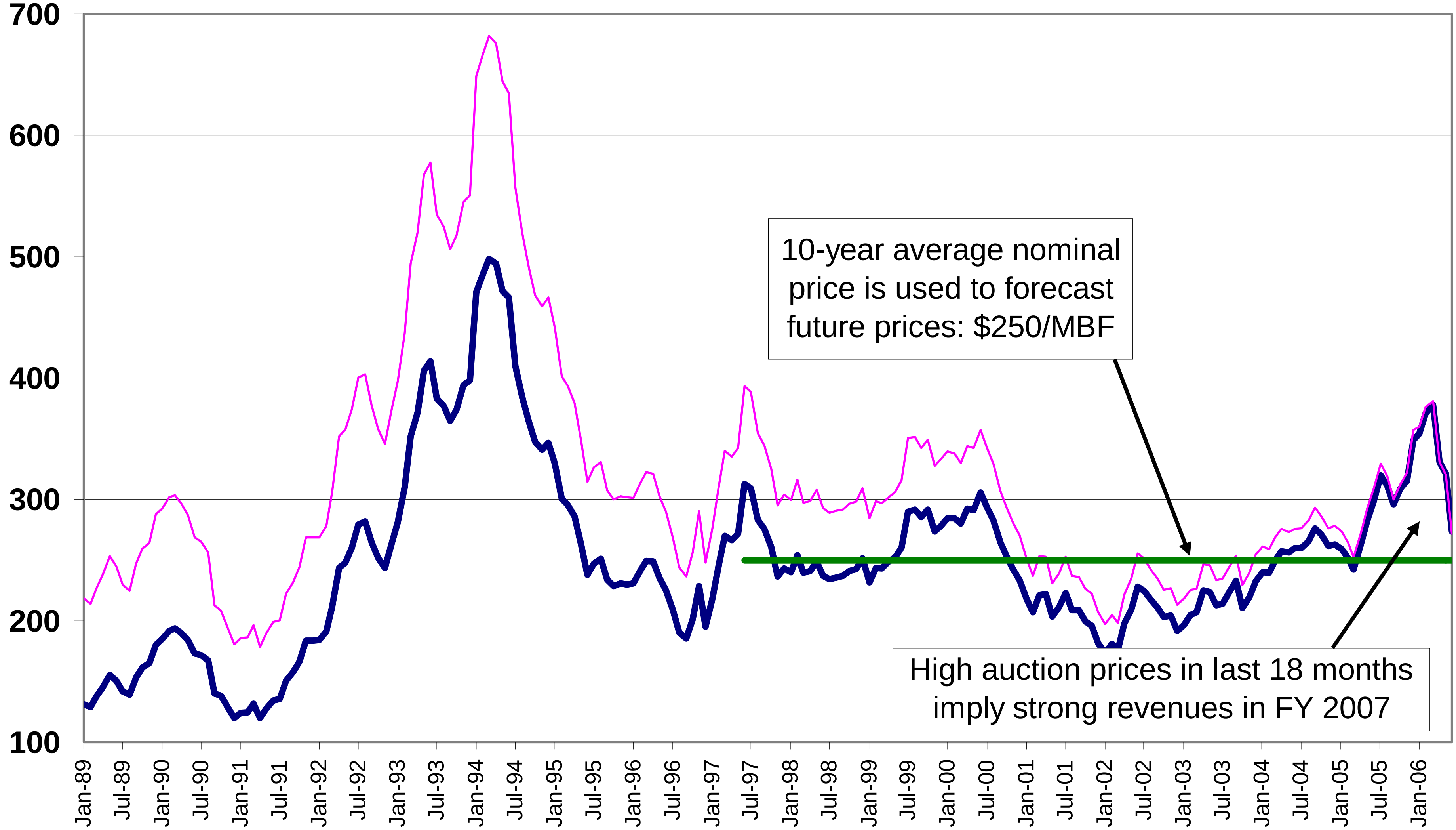
At beginning of 2001, distribution for 2002 was set at $48 million. At a 50% target coverage, this would require $24 million, but only had $12 million at the time. High income in 2001 avoided a shortfall.

At beginning of 2002, distribution for 2003 was set at $43 million. At a 50% target coverage, this would require $22 million, but only had $16 million at the time. Drop in income in 2002 and 2003 boosted payouts above 100%, resulting in $7 million holdback.

Distribution for 2004 was set in early 2003. Reserves were very low at $3 million, but no shortfall occurred because net revenues were strong and payout ratio dropped below 100% in 2004.

At the beginning of 2004, distributions were set at $23 million for 2005. Despite low coverage, distributions were not impaired because payout remained below 100%, allowing Earnings Reserves to grow.

Idaho Department of Lands Log Price Trends (at Bid)
Actual and Inflation Adjusted -- Six Month Rolling Ave



A drop in 10-yr average timber prices from $250 to $200 would impair Net Revenues

Issues Remaining

- Robust testing of the new model
  - Current version has been only partially vetted by the Reform Review Task Force
- Further understanding of lands revenue volatility, other uncertainties
  - Properly reflecting differences among funds, other potential downsides
- Do we need a policy on when Earnings Reserves should be transferred to the Permanent Fund?

Financial Summary

Total Endowment Cash Flows

(millions of dollars)

	2004	2005	2006	2007 Forecast	2008 Forecast	3 Yr Ave Net Rev.
Beginning Value Earnings Reserve	19	33	54	99	133	
Net Land Revenues	50	38	47	50	51	45
Net EFIB Income	14	17	19	20	19	17
Change in Market Value	5	4	6	-	-	
Distributions to beneficiaries*	(55)	(37)	(36)	(36)	(52)	
Ending Earnings Reserves Fund	33	54	91	133	150	
Total Revenues/Market	69	58	73	70	70	62
Net after distributions	14	21	37	34	18	

Sustainability:	*Payout Ratio of '04-'06 Net Revenues*			*85%*
	Payout Ratio of 2008 Net Revenues			*75%*
Safety:	*Coverage Ratio of 2008 Distribution*	*189%*	*253%*	*287%*

* 2008 using "Safe" scenario. "Safer" scenario is $47 million

2008 Land Revenues of $51MM reflects a 7% discount from Lands' forecast of timber revenues

Conclusions

- Payout of fund revenues has been relatively low in recent years for most endowments
- As a result, Earnings Reserve balances and coverage ratios have hit new highs
  - Further improvement in FY2007 is likely
- The increase in distributions called for by the "Safe and Sustainable" policy for selected endowments is prudent – the likelihood of a future cutback is low
  - Even with the increase, payouts for all endowments remain below 100% of Net Revenues
  - Every fund is expected to have 200% of 2008 distributions in reserve at the end of 2007